Supreme Court, U.S.
FILED
NOV 17 1993
CLERK

No. 93-486

In the Supreme Court of the United States

OCTOBER TERM, 1993

FRANK KELLY, ET AL., PETITIONERS

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

BENNETT FALK
MORGAN, LEWIS & BOCKIUS
5300 Southeast Financial Center
200 South Biscayne Boulevard
Miami, Florida 33131
(305) 579-0390

PETER BUSCEMI *
JOHN P. SIMMONS
MORGAN, LEWIS & BOCKIUS
1800 M Street, N.W.
Washington, D.C. 20036
(202) 467-7190
Counsel for Respondent
* Counsel of Record

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

BEST AVAILABLE COPY

QUESTIONS PRESENTED

This case involves the res judicata effect of a district court judgment against petitioners and in favor of respondent Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch"). That judgment was affirmed by the court of appeals, and petitioners did not seek review in this Court. Soon after the district court entered its judgment, petitioners began an arbitration against Merrill Lynch. The arbitration arose from the same facts as the earlier district court litigation, but petitioners asserted a theory of liability diametrically opposite from the one that they had pursued unsuccessfully in the district court. Merrill Lynch asked the district court to enforce its own judgment and enjoin the arbitration on res judicata grounds. The district court entered the requested injunction, and the court of appeals again affirmed. The questions presented are:

1. Whether the district court was entitled to consider and decide Merrill Lynch's claim of res judicata.

2. Whether the district court properly ruled that petitioners' arbitration is barred by res judicata.

STATEMENT UNDER RULE 29.1

In accordance with Rule 29.1 of the Rules of this Court, respondent Merrill Lynch, Pierce, Fenner & Smith, Inc. states that its parent company is Merrill Lynch & Co., Inc. and that it has the following subsidiaries (other than wholly owned subsidiaries):

Merrill Lynch Life Agency, Inc. (Ohio)
Merrill Lynch Life Agency, Inc. (Oklahoma)
Merrill Lynch Life Agency, Ltd. (Mississippi)
Merrill Lynch-Nomura Management Company, Inc.
ML Life Agency Inc.
Wagner Stott Clearing Corp.

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED	i
STATEMENT UNDER RULE 29.1	ii
TABLE OF AUTHORITIES	iv
STATEMENT OF THE CASE	1
A. The Trading Activity That Gave Rise To Petitioners' Claims	1
B. Petitioners' Federal Lawsuit	3
C. Petitioners' Claims In Arbitration	5
D. Merrill Lynch's Request For An Injunction On The Ground Of Res Judicata	6
E. The Decisions Below	7
ARGUMENT	9
I. THE DISTRICT COURT WAS ENTITLED TO ENFORCE ITS OWN JUDGMENT AND ADDRESS MERRILL LYNCH'S CLAIM OF RES JUDICATA	10
II. THE COURTS BELOW CORRECTLY CONCLUDED THAT PETITIONERS' ARBITRATION IS BARRED BY RES JUDICATA	14
CONCLUSION	21
APPENDIX	1a

TABLE OF AUTHORITIES

CASES — Page

American Train Dispatchers Assoc. v. Burlington N. R.R. Co., 784 F. Supp. 899 (D.D.C. 1992) 12
Ank Shipping Co. v. Seychelles Nat'l Commodity Co., Ltd., 596 F. Supp. 1455 (S.D.N.Y. 1984) 13
Blue Gray Corporations I & II v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 921 F.2d 267 (11th Cir. 1991) 18
Burmah Oil Tankers, Ltd. v. Trisun Tankers, Ltd., 687 F. Supp. 897 (S.D.N.Y. 1988) 13
Clark v. Bear Stearns & Co., 966 F.2d 1318 (9th Cir. 1992) 19
Clemens v. Central R.R. Co. of New Jersey, 399 F.2d 825 (3d Cir. 1968), *cert. denied*, 393 U.S. 1023 (1969) 12
Commissioner v. Sunnen, 333 U.S. 591, 597 (1948) 15
Dean Witter Reynolds v. Byrd, 470 U.S. 213 (1985) 10, 11
E.C. Ernst, Inc. v. Manhattan Construction Co., 551 F.2d 1026 (5th Cir.), *modified on petition for reh'g*, 559 F.2d 268, 269 (5th Cir. 1977), *cert. denied*, 434 U.S. 1067 (1978) 21
Enterprise Ass'n Metal Trades Branch Local Union 638 v. Empire Mechanical, Inc., 122 Lab. Cas. ¶ 10,284, 1992 Westlaw 84689 (S.D.N.Y. 1992) 10-11
Federated Department Stores, Inc. v. Moitie, 452 U.S. 394 (1981) 15
Fremont Cake & Meal Co. v. Wilson & Co., Inc., 183 F.2d 57 (8th Cir. 1950) 12
Hart Steel Co. v. Railroad Supply Co., 244 U.S. 294, 299 (1917) 15
International Ladies' Garment Workers' Union v. Ashland Indus., Inc., 488 F.2d 641 (5th Cir.), *cert. denied*, 419 U.S. 840 (1974) 14
Interstate Pipe Maintenance, Inc. v. FMC Corp., 775 F.2d 1495, 1497 (11th Cir. 1985) 15
J.D. Marshall International, Inc. v. Redstart, Inc., 656 F. Supp. 830 (N.D. Ill. 1987) 16

TABLE OF AUTHORITIES—Continued

	Page
John Alden Life Ins. Co. v. Cavendes, 591 F. Supp. 362, 367 (S.D. Fla. 1984)	16
Liberty Univ., Inc. v. Kemper Sec. Group, Inc., 758 F. Supp. 1148 (W.D. Va. 1991)	14
Local Union No. 4-243, Oil Workers Int'l Union v. Mobil Oil Corp., 558 F.2d 233 (5th Cir. 1977)	14
Midwest Window Systems v. Amcor Industries, 630 F.2d 535 (7th Cir. 1980)	20
Miller Brewing Co. v. Fort Worth Distributing Co., 781 F.2d 494 (5th Cir. 1986)	12-13
National R.R. Passenger Corp. v. Boston and Maine Corp., 850 F.2d 756 (D.C. Cir. 1988)	14
National Shipping & Trading Corp. v. Buck Shipping Int'l Ltd., No. 81 Civ. 3818-CSH (S.D.N.Y. April 3, 1985)	13
New Process Steel Corp. v. Tital Indus. Corp., 555 F. Supp. 1018 (S.D. Tex. 1983)	19
Olmstead v. Amoco Oil Co., 725 F.2d 627, 632 (11th Cir. 1984)	15
Peterson v. Shearson/American Express, Inc., 849 F.2d 464, 467-68 (10th Cir. 1988)	21
Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395 (1967)	10, 11
Rodriquez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477 (1989)	9
S & H Contractors, Inc. v. A.J. Taft Coal Co., 906 F.2d 1507 (11th Cir. 1990), *cert. denied*, 498 U.S. 1026 (1991)	20
Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987)	9
Sprague & Rhodes Commodity Corp. v. Instituto Mexicano Del Cafe, 566 F.2d 861 (2d Cir. 1977)	12
Stone v. E.F. Hutton & Co., 898 F.2d 1542 (11th Cir. 1990)	20
Telephone Workers Union, Local 827 v. New Jersey Bell Tel. Co., 584 F.2d 31 (3d Cir. 1978)	12

TABLE OF AUTHORITIES—Continued

Page

Virginia Carolina Tools, Inc. v. International Tool Supply, Inc., 793 F. Supp. 664 (W.D.N.C. 1992), *aff'd*, 984 F.2d 113 (4th Cir.), *cert. denied*, 113 S. Ct. 2930 (1993) 14
Wilko v. Swan, 346 U.S. 427 (1953) 9

STATUTES AND REGULATIONS

17 C.F.R. § 240.10b-5 3
17 C.F.R. § 240.10b-16 3
Federal Arbitration Act, 9 U.S.C. §§ 1 *et seq.* 10
Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) 3

OTHER AUTHORITIES

Currie, *Res Judicata: The Neglected Defense*, 45 U. Chi. L. Rev. 317 (1978) 15

In the Supreme Court of the United States

OCTOBER TERM, 1993

No. 93-486

FRANK KELLY, ET AL., PETITIONERS

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

Respondent Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch"), by its undersigned counsel, submits this brief in opposition to the petition for a writ of certiorari in this case.

STATEMENT OF THE CASE

A. The Trading Activity That Gave Rise To Petitioners' Claims

Petitioner Frank Kelly is a former Merrill Lynch account executive. The other petitioners are Kelly's wife and 15 of Kelly's former customers, including one corporate investor.[1] During the period from late 1982

[1] Many of the relevant facts are set forth in the district court's opinion granting summary judgment for Merrill Lynch. That opinion, which is unreported, was not reproduced in the appendix to the petition. It is reprinted as an appendix to this brief.

through late 1986, all of the petitioners, including Kelly and his wife, opened individual or joint trading accounts at the Merrill Lynch office in Coral Gables, Florida, where Kelly worked.

Petitioner Kelly, by his own admission an experienced and knowledgeable investor who had been employed as a securities broker with both Dean Witter and PaineWebber before working for Merrill Lynch, devised an investment strategy that petitioners used in trading stock index options. The strategy involved the short sale of options based on the Standard & Poor's 100 stock index. These options, known by the trading symbol "OEX", are traded on the Chicago Board of Options Exchange. Kelly's strategy generally consisted of the simultaneous sale of OEX "calls" (*i.e.*, options to buy) and OEX "puts" (*i.e.*, options to sell). Petitioners' sales of these options were "short" sales because petitioners sold options that they did not own at the time of sale. Petitioners could earn a profit if the options expired unexercised (thus enabling petitioners to retain the full price they received when they sold the options), or if the price of the options declined (thus enabling petitioners to cover their "short" positions and retain the difference between the price at which they had sold the options and the price at which they subsequently purchased them).

Petitioners' strategy could be successful only in periods of relative market stability. As the district court observed (App. 3a), in periods of market volatility, "this kind of trading results in losses." If the market moves sharply up, the prices of "calls" increase significantly; if the market moves sharply down, the prices of "puts" increase significantly. In either event, those increases can produce substantial losses for short sellers, losses that are by no means limited by the amount of the original price at which an option was sold.

When petitioners opened their accounts, they received all of the required disclosure documents, including a brochure entitled "Characteristics and Risks of Standardized Options," which detailed in plain language the operation of standardized option markets. Petitioners also signed a "Standard Option Agreement" and a "Customer Agreement". These documents clearly spelled out the risks of options trading. In addition, Kelly himself advised each petitioner on the trading of index options. Against the background of these disclosures, each petitioner individually chose to engage in the trading strategy masterminded by Kelly.

In early 1987, "the stock market moved dramatically against the option positions held by [petitioners]." App. 3a. Accordingly, Merrill Lynch exercised its right to require petitioners to increase the amount of money on deposit in petitioners' accounts to ensure petitioners' ability to perform their obligations with respect to the options sold short. Some petitioners initially complied with Merrill Lynch's new requirements, but most did not. As the market continued to move against petitioners' positions, Merrill Lynch bought the options needed to close petitioners' short positions and charged petitioners' accounts for the purchase price of those options. As a result, petitioners realized the losses that they had suffered due to the adverse movement of the market. App. 3a-4a, 5a n.4.

B. Petitioners' Federal Lawsuit

In December 1987, petitioners sued Merrill Lynch in the United States District Court for the Southern District of Florida, alleging violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Securities and Exchange Commission Rules 10b-5 and 10b-16 promulgated under that statute, 17 C.F.R. § 240.10b-5 and § 240.10b-16. Petitioners charged Merrill Lynch with fraud in connection with the purchase or sale of securities, in violation of Rule 10b-5, and with inadequate disclosure of credit terms and information

regarding the extension of credit in securities transactions, in violation of Rule 10b-16. The thrust of both claims was that Merrill Lynch had improperly raised the collateral requirements for petitioners' short sales of stock index options and that, as a result, petitioners' existing positions were prematurely liquidated and petitioners were precluded from continuing with their trading strategy—a strategy that, according to petitioners' allegations, eventually would have produced substantial profits.

After more than two years of litigation and extensive discovery, Merrill Lynch moved for summary judgment on both counts of the complaint. With respect to the Rule 10b-16 count, Merrill Lynch explained that petitioners' options trading did not involve any extensions of credit, that in fact options are not permitted to be purchased or sold on credit, and that therefore the rule simply did not apply to the transactions about which petitioners were complaining. Petitioners then decided to "narrow the focus" of their case by moving to dismiss their Rule 10b-16 claim without prejudice. Petitioners informed the district court that they could "obtain all the relief necessary to make them whole through their 10b-5 claim." App. 5a n.3. The district court correctly ruled that the Rule 10b-16 count should be dismissed *with* prejudice, and petitioners did not challenge that decision.

Turning to the Rule 10b-5 count, Merrill Lynch argued (1) that Merrill Lynch did not make any misstatement or omission of material fact; (2) that Merrill Lynch did not act with scienter; and (3) that Merrill Lynch did not proximately cause any of the losses suffered by appellants. The district court granted summary judgment for Merrill Lynch on the grounds that petitioners had not adduced sufficient evidence to create any genuine issue of material fact with respect to the scienter and loss causation elements of the 10b-5 claim. App. 5a-16a. The court of appeals summarily affirmed. 948 F.2d 1297 (1991).

C. Petitioners' Claims In Arbitration

In August 1990, three weeks after the district court granted summary judgment, and nearly three and one half years after the latest of the operative events, petitioners began the controversy all over again by initiating an arbitration against Merrill Lynch before the National Association of Securities Dealers, Inc. ("NASD"). Having failed in their effort to blame Merrill Lynch for terminating their trading strategy, petitioners abandoned that theory and switched to one looking in precisely the opposite direction.

Suddenly, the trading strategy that, according to petitioners' submissions in the district court, would have led inexorably to profits became a strategy that was flawed from the outset. Petitioners contended that their short sales of index options were unsuitable investments in view of petitioners' investment objectives, investment experience, and net worth. They also alleged that Merrill Lynch failed to supervise adequately the trading in petitioners' accounts and the activities of petitioner Kelly. In addition, petitioners complained about Merrill Lynch's alleged failure to disclose adequately the risks of petitioners' trading strategy and to subject petitioners' trading to the firm's customary approval process. Based on these allegations, petitioners asserted state law claims of breach of fiduciary duty, negligence, breach of contract, and negligent misrepresentation.

Petitioners sought in the arbitration to recover the very losses that they had tried unsuccessfully to recoup in the federal litigation. Their claims in arbitration, however, marked an abrupt about-face from the theories that petitioners had attempted unsuccessfully to foist on the district court during nearly three years of litigation (and that petitioners continued to pursue in the court of appeals even after the arbitration was under way). Petitioners withheld these new claims from the district court, but it was not for lack of the legal ability to raise those

claims in the litigation. Indeed, petitioners themselves conceded in the district court that that court "would have enjoyed subject-matter jurisdiction as a technical matter . . . ." R2-153, at 9 (Petitioners' Motion to Compel Arbitration). Rather, petitioners refrained from pursuing their common law claims in the litigation for the obvious practical reason that the gross inconsistencies in their position would have done irreparable damage to their credibility before the district court.

D. Merrill Lynch's Request For An Injunction On The Ground Of Res Judicata

Merrill Lynch undertook discovery in the arbitration, largely for the purpose of confirming what seemed apparent from petitioners' Statements of Claim, namely, that petitioners were simply trying to assert new claims based on the same facts that had already been litigated. Once the pre-hearing preparation had been completed, and petitioners had failed to identify any new facts on which they were seeking to rely, Merrill Lynch returned to the district court and moved for an order enforcing the district court's judgment and precluding petitioners from proceeding with the arbitration. Merrill Lynch explained that "[b]ecause the claims raised by appellants in the arbitration arose not only from the same nucleus of operative facts, but the *identical set of facts*, and could have been raised in this action, they are barred by *res judicata*." R2-151, at 2 (emphasis in original).

Petitioners opposed Merrill Lynch's motion and moved to compel arbitration. Petitioners first argued that the res judicata claim could be decided only in the arbitration and that, in any event, the district court lacked authority to enjoin petitioners from proceeding with the arbitration. As to the merits of the res judicata claim, petitioners relied primarily on the arbitration clause in their customer agreements with Merrill Lynch, contending that this constituted a waiver of any right to assert the preclusive effect of the district court's judgment. Although conceding that

the district court would have had subject-matter jurisdiction over petitioners' pendent state law claims, petitioners also attempted to argue that their arbitration claims "could not have been raised in the prior federal-court action," because Merrill Lynch could have sought to compel arbitration of those claims. R2-153, at 2-3.

E. The Decisions Below

The district court rejected petitioners' arguments and entered an order enjoining petitioners from proceeding with their arbitration. Pet. App. B-1 to B-5. The court explained:

> where Plaintiffs attempt to relitigate in another tribunal claims decided by a federal court, the court may properly enjoin those proceedings. Under the doctrine of *res judicata*, the parties are prohibited from relitigating a final judgment "as to all claims that were raised or could have been raised [in the federal proceeding]." . . . The prohibition on relitigation includes those state claims that could have been brought in federal court under the doctrine of pendent jurisdiction, that is, claims which arise out of the same "operative nucleus of fact."
>
> . . . Plaintiffs' claims arise from the same "operative nucleus of fact" as their 10(b)(5) claim, which was previously adjudicated by this Court. . . .
>
> . . . Allowing NASD to determine whether the claims are barred by the doctrine of *res judicata* clearly would fail to protect the district court's final judgment. Rather than waiting until this Court decided the merits of their 10(b)(5) claim to raise these additional claims, the Plaintiffs should have brought the pendent claims in the federal action in December of 1987—regardless of whether Merrill Lynch could have compelled arbitration of these claims. If Plaintiffs had brought all of their claims at that time, this Court could have determined the best manner to adjudicate all of Plaintiffs' claims

> without the possibility of conflicting decision by various tribunals on the same issues.

Pet. App. B-3 to B-4 (citations omitted; brackets in original).

The court of appeals affirmed. Pet. App. A-1 to A-7. The court rejected petitioners' argument that the res judicata issue could be decided *only* in the arbitration. The court did not seek to preclude arbitrators from addressing res judicata claims, but it did insist that courts must be permitted to protect their own judgments, even in the face of a demand for arbitration. In the court's words, "the better rule is that courts can decide res judicata. . . . Courts should not have to stand by while parties re-assert claims that have already been resolved. . . . The issue is not just one of preventing the piecemeal litigation that occurs when parties simultaneously assert claims in several forums, but of protecting prior judgments." Pet. App. A-4 to A-5.

Turning to the merits, the court of appeals sustained the district court's injunction. The court rejected petitioners' attempt to characterize the arbitration clause in the parties' customer agreements as a waiver of res judicata or a blanket authorization to split claims. The court stated (Pet. App. A-5):

> We cannot read the agreement as an express or implied waiver of res judicata. The agreement simply allowed [petitioners] to institute two suits based on the same events. Nothing shows that the parties understood—or that [Merrill Lynch] led [petitioners] to believe—that the end of the first action would not preclude the start of the second.

Because petitioners could have raised all of their claims in the district court, and the district court would have had pendent or diversity jurisdiction over all of those claims, the court of appeals upheld the district court's injunction. The court correctly ruled that speculation about whether Merrill Lynch could have or would have

sought to compel arbitration of the state law claims is not relevant to the res judicata determination. Pet. App. A-6 to A-7.

ARGUMENT

The court of appeals' decision is correct, and further review is not warranted. Despite petitioners' hyperbole, no unresolved or controversial question of federal law is presented here. Federal district courts have the unquestioned authority to protect and enforce their own judgments, and nothing in the Federal Arbitration Act was intended to remove or restrict that authority. Similarly, the arbitration clause in the parties' customer agreements did not address, much less waive, the res judicata protection. Rather, it simply enabled either party to compel arbitration of state law claims. It said nothing about arbitrations not commenced until after an adverse federal judgment on the same facts. There is no conflict among the circuits with regard to any of the issues that petitioners seek to present, no conflict with general federal policy, and no conflict with any decision of this Court.

Moreover, the contractual arbitration clause that has given rise to the present dispute is a remnant of a bygone era during which, as a result of this Court's decision in *Wilko v. Swan*, 346 U.S. 427 (1953), agreements to arbitrate under the federal securities laws were not enforceable. Arbitration clauses, like the one at issue here, therefore acknowledged that securities law claims could be litigated. Now, however, *Wilko* has been overruled in *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987), and *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989), and most customer agreements between brokerage firms and investors provide for arbitration of all claims, including claims under the securities laws. Accordingly, the situation presented here is unlikely to recur, and the petition for review should be denied.

I. THE DISTRICT COURT WAS ENTITLED TO ENFORCE ITS OWN JUDGMENT AND ADDRESS MERRILL LYNCH'S CLAIM OF RES JUDICATA

Petitioners' characterization of the lower courts' rulings is inaccurate. Neither the district court nor the court of appeals "carved out a broad and unprecedented exception" (Pet. 5) to the important federal policies embodied in the Federal Arbitration Act, 9 U.S.C. §§ 1 *et seq.* Rather, the court of appeals, in affirming the district court's ruling, expressly recognized that courts ordinarily should not reach the merits of arbitrable issues. Pet. App. A-4 (citing *Dean Witter Reynolds v. Byrd*, 470 U.S. 213, 218 (1985); *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967)). The courts below also recognized, however, what petitioners would prefer to ignore, namely, that federal courts have well-established authority to enforce their own judgments and to determine the res judicata effect of prior decisions.

None of the authorities on which petitioners rely deals with a claim of res judicata or with a district court's authority to enforce its prior judgments. Petitioners' arguments simply disregard the significance of the district court's final judgment in favor of Merrill Lynch. The Federal Arbitration Act does not address the question of how a claim of res judicata based on a district court judgment should be resolved; certainly the Act does not purport to impose limits that would not otherwise exist on the authority of district courts to effectuate their decisions. Likewise, the cases on which petitioners rely simply do not address a district court's authority *vel non* to enforce its own judgments by refusing to permit a party from pursuing in another forum claims that were or could have been raised in a case that the district court has already decided.[2]

---

[2] Contrary to petitioners' assertion (Pet. 7 n.5), the unreported district court decision cited by the court of appeals did not involve a situation like that presented here. Instead, *Enterprise Ass'n*

Prima Paint Corp., for example, is inapposite precisely because it does not involve the preclusive effect of a prior district court judgment. The case held that a defense of "fraud in the inducement" as to the contract as a whole (not merely the arbitration agreement) is an issue on the merits for the arbitrators to decide. 388 U.S. at 404. Here, however, Merrill Lynch did not ask the district court to evaluate the underlying merits of the parties' conduct; it sought merely to give effect to the court's own final judgment, *separately* from and *independently* of the arbitration.

Similarly, petitioners' reliance on *Dean Witter Reynolds v. Byrd* is misplaced. *Byrd* held that arbitrable and non-arbitrable claims may proceed *simultaneously* in an arbitral forum and a court. *Byrd* did *not* hold that an arbitration may proceed even *after* there has been a final judgment entered in the court action. To the contrary, this Court expressly acknowledged that a prior decision in one forum could have a preclusive effect in the other, and it left to the lower federal courts the task of determining, in the first instance, to what extent and under what circumstances arbitration decisions should be given preclusive effect in litigation. 470 U.S. at 222-23. The Court never suggested that the federal policy favoring arbitration somehow bars federal district courts from enforcing their own judgments or that the courts are not the appropriate entities to determine the preclusive effect of their own decisions.

Metal Trades Branch Local Union 638 v. Empire Mechanical, Inc., 122 Lab. Cas. ¶ 10,284, 1992 Westlaw 84689 (S.D.N.Y. 1992), involved a defendant corporation that unsuccessfully asserted a res judicata defense during the course of an arbitration and then tried to reassert that defense when the arbitration claimant sought judicial enforcement of the arbitration award. The district court refused to reconsider a defense already rejected by the arbitration panel. Such a defense, the court said, is "not for the Court on a petition to confirm the award." Slip op. at 2-3.

General discussions about the extent to which federal law encourages arbitration are no substitute for precedent dealing with the discrete issue presented here. That issue is whether a district court, having fully adjudicated a controversy between two parties through protracted litigation extending over a period of years, must sit idly by while the unsuccessful party attempts, in derogation of the district court's judgment, to relitigate its case in another forum on the basis of a new theory inconsistent with the one previously litigated. The courts below correctly held that the answer to this question is negative.

Petitioners inaccurately depict the court of appeals' ruling as "ignor[ing] fifty years of federal precedent." Pet. 8. In fact, federal courts have long exercised their inherent power to determine the res judicata effect of prior federal court rulings notwithstanding parties' agreements to submit the merits of their disputes to arbitration.[3] Perhaps the leading decision is *Miller Brewing Co.*

---

[3] *See, e.g., Telephone Workers Union, Local 827 v. New Jersey Bell Tel. Co.*, 584 F.2d 31, 33 (3d Cir. 1978) ("When a federal court is presented with the contention that a prior federal judgment determined issues now sought to be relitigated in an arbitral forum [the court] must first determine the effect of the judgment. . . . The federal policy favoring [arbitration] clauses . . . does not come into play until the court first determines whether prior completed litigation has already finally determined all issues."); *Sprague & Rhodes Commodity Corp. v. Instituto Mexicano Del Cafe*, 566 F.2d 861, 863 (2d Cir. 1977) (instructing district court in appropriate circumstances to determine *res judicata* effect of a foreign judgment on a petition to compel arbitration); *Clemens v. Central R.R. Co. of New Jersey*, 399 F.2d 825 (3d Cir. 1968) (holding plaintiffs' claims barred by *res judicata* and not properly submitted to arbitration), *cert. denied*, 393 U.S. 1023 (1969); *American Train Dispatchers Assoc. v. Burlington N. R.R. Co.*, 784 F. Supp. 899, 903 (D.D.C. 1992) ("[C]ourts have the right of plenary review when asked to determine the preclusive effects of a federal judgment on relitigation of the same issues in an arbitral forum. If we have finally decided something as a matter of law, an arbitral panel may not completely disregard that conclusion."); *Fremont Cake & Meal Co. v. Wilson & Co., Inc.*, 183 F.2d 57 (8th Cir. 1950) (holding that district court properly determined that, based on

v. Fort Worth Distributing Co., 781 F.2d 494 (5th Cir. 1986), which petitioners relegate to a footnote in this Court, as they did in the court of appeals. *See* Pet. 7-8 n.5. *Miller Brewing* held that a res judicata defense constitutes "good ground for enjoining arbitration proceedings," and that "parties should be barred from seeking relief from arbitration panels when, under the doctrine of *res judicata*, they would be barred from seeking relief in the courts." *Id.* at 498, 499. The court of appeals explicitly rejected the very kind of argument made by petitioners based on federal law's general encouragement of arbitration:

> We are mindful of the admonition . . . that arbitration is ordinarily preferable to litigation, but to allow arbitration on top of the protracted litigation in this case would be to add insult to injury. The doctrine of res judicata . . . [has] probably done more to prevent useless and wasteful litigation than arbitration ever could.

Id. at 497 n.3. Although res judicata provides what is probably the strongest justification for a judicial refusal to defer indiscriminately to arbitration, petitioners are also misinformed in their contention that the court of appeals has singled out the claim of res judicata as the sole bar to arbitration that can ever be considered by a

---

prior adjudication, there was no controversy to arbitrate and properly dismissed with prejudice the action to compel arbitration); *Burmah Oil Tankers, Ltd. v. Trisun Tankers, Ltd.*, 687 F. Supp. 897, 899 (S.D.N.Y. 1988) ("A federal court may enjoin state court actions that threaten to relitigate and impair a federal judgment. It would be incongruous if the federal courts could not exercise the same power to protect judgments against later arbitration proceedings."); *National Shipping & Trading Corp. v. Buck Shipping Int'l Ltd.*, No. 81 Civ. 3818-CSH (S.D.N.Y. April 3, 1985) ("an asserted *res judicata* bar is appropriate for consideration by the court in a motion to compel (or to stay) arbitration"); *Ank Shipping Co. v. Seychelles Nat'l Commodity Co., Ltd.*, 596 F. Supp. 1455 (S.D.N.Y. 1984) (holding petition to compel arbitration barred by res judicata).

district court. Federal courts have addressed a number of other arguments that, if found meritorious, similarly would preclude the need for an arbitration to address the merits of the dispute.[4]

The court of appeals therefore was correct in concluding that "the better rule is that courts can decide res judicata." Pet. App. A-4. The federal policy favoring arbitration is not implicated until the district court has had an opportunity to decide the issue of whether or not all claims have already been resolved by prior litigation.

II. THE COURTS BELOW CORRECTLY CONCLUDED THAT PETITIONERS' ARBITRATION IS BARRED BY RES JUDICATA

Petitioners do not take issue with the district court's finding that their state law claims arise from the same "operative nucleus of fact" as the 10(b)(5) claim that was previously adjudicated by the district court. Pet.

---

[4] *See, e.g., National R.R. Passenger Corp. v. Boston and Maine Corp.*, 850 F.2d 756 (D.C. Cir. 1988) (holding that the court rather than the arbitrator properly considered the defense that the duty to arbitrate did not survive the termination date of the agreement); *Local Union No. 4-243, Oil Workers Int'l Union v. Mobil Oil Corp.*, 558 F.2d 233 (5th Cir. 1977) (holding that the district court properly considered the background and setting of the dispute in addressing the defense that there was no remaining dispute for the arbitrators to arbitrate); *International Ladies' Garment Workers' Union v. Ashland Indus., Inc.*, 488 F.2d 641 (5th Cir.), *cert. denied*, 419 U.S. 840 (1974) (holding that, in labor dispute, district court rather than arbitrator should determine whether, in arbitration subsequent to district court ruling on the same facts, an inconsistent defense should be barred); *Virginia Carolina Tools, Inc. v. International Tool Supply, Inc.*, 793 F. Supp. 664 (W.D.N.C. 1992), *aff'd*, 984 F.2d 113 (4th Cir.), *cert. denied*, 113 S. Ct. 2930 (1993) (holding that the court rather than the arbitrators properly considered the defense that a contract had not been extended beyond its expiration date by the parties); *Liberty Univ., Inc. v. Kemper Sec. Group, Inc.*, 758 F. Supp. 1148 (W.D. Va. 1991) (holding that the court rather than the arbitrator properly considered the defense that the duty to arbitrate did not survive the termination date of the agreement).

App. B-4. Nor do petitioners deny that, as they themselves conceded in the district court, that court would have had jurisdiction over the claims that petitioners later sought to arbitrate. Pet. App. B-4; *see also* Pet. App. A-6. Petitioners were thus able to bring all of their claims in the district court, but they failed to do so. When the district court then entered a final judgment on the claims that *were* litigated, the pendent state law claims were lost forever.

As this Court held in *Federated Department Stores, Inc. v. Moitie*, 452 U.S. 394 (1981), "[a] final judgment on the merits of an action precludes the parties or their privies from relitigating issues that were *or could have been raised* in that action." *Id.* at 398 (emphasis added). The Court in *Federated Department Stores* reiterated the importance of res judicata: " '[the] doctrine of *res judicata* is not a mere matter of practice or procedure inherited from a more technical time than ours. *It is a rule of fundamental and substantial justice . . . which should be cordially regarded and enforced by the courts . . . .*' " *Id.* at 401, quoting *Hart Steel Co. v. Railroad Supply Co.*, 244 U.S. 294, 299 (1917) (brackets in original) (emphasis added). *See also Commissioner v. Sunnen*, 333 U.S. 591, 597 (1948); Currie, *Res Judicata: The Neglected Defense*, 45 U. Chi. L. Rev. 317, 325 (1978) ("to allow a party to advance arguments in a second proceeding that he could have made in a prior proceeding but did not . . . imposes unnecessary costs on both opposing parties and the judicial system").

Res judicata "extends not only to the precise legal theory presented in the previous litigation, but to all legal theories and claims arising out of the same 'operative nucleus of fact.' " *Olmstead v. Amoco Oil Co.*, 725 F.2d 627, 632 (11th Cir. 1984). *See also Interstate Pipe Maintenance, Inc. v. FMC Corp.*, 775 F.2d 1495, 1497 (11th Cir. 1985) ("final judgment by a court of competent jurisdiction bars a subsequent suit between the same parties and on the same cause of action not only

as to all matters that were litigated in the first proceeding but also as to all issues that could have been litigated"); *John Alden Life Ins. Co. v. Cavendes*, 591 F. Supp. 362, 367 (S.D. Fla. 1984) ("*Res judicata* precludes all claims which might have been made by the parties in the earlier case as well as those issues that were actually litigated").

In *J.D. Marshall International, Inc. v. Redstart, Inc.*, 656 F. Supp. 830 (N.D. Ill. 1987), the district court recognized that a federal judgment can have "full *res judicata* and collateral estoppel effects" on a pending arbitration. The parties had contractually agreed that either one of them could compel arbitration as to claims arising out of the sale of an export business from Redstart to JDM. After differences arose between the parties, JDM filed a federal RICO claim in federal court and a complaint in arbitration. The court observed that, as in the present case, the claims in the two proceedings were based on the same underlying facts: "The predicate offenses JDM alleges in its RICO claims are based entirely on transactions underlying its breach of contract claims in the arbitration proceeding." *Id.* at 834. The court then decided to stay the federal action in recognition of the fact that "[i]f JDM's action here proceeds to judgment first, that judgment would have full *res judicata* and collateral estoppel effects on the arbitration . . . ." *Id.*

Because a judgment rendered in a contemporaneous federal action has res judicata effect on a *pending* arbitration, it irrefutably has the same effect on a *subsequently filed* arbitration. At the outset of this litigation, petitioners had the following choices: (1) file in federal court a 10b-5 and 10b-16 action for only some of their claims and forgo any remaining claims; (2) file in federal court all possible claims, even if the claims that petitioners later sought to arbitrate were inconsistent with petitioners' primary litigation theory; (3) file all claims in arbitration; or (4) proceed simultaneously in litigation and arbitration, recognizing the potential preclusive effect of the decision rendered first. Petitioners chose none of

these options. Instead, they chose the one option that was not available to them. They litigated some of their claims to a conclusion in federal court, lost, and then filed a subsequent arbitration seeking the same recovery. The doctrine of res judicata does not permit that option.

Petitioners do not dispute these basic res judicata principles. Rather, they contend that the arbitration clause in the customer agreements they signed with Merrill Lynch renders the res judicata doctrine ineffective or inapplicable. Petitioners reach this conclusion by two different routes.

First, they argue (Pet. 11-13) that the arbitration clause "is an explicit written consent to the splitting of Petitioners' claims." Second, they assert (Pet. 16) that, as a result of the arbitration clause, "Petitioners were precluded by contract from pursuing their state-law claims in federal court." Both arguments are without merit.

We begin with the language of the arbitration clause. Petitioners' customer agreements with Merrill Lynch provided:

> Except to the extent that controversies involving claims arising under the federal securities laws may be litigated, any controversy between us arising out of such option transactions or this agreement shall be settled by arbitration only before the National Association of Securities Dealers, Inc. or the New York Stock Exchange, or an Exchange located in the United States upon which listed options transactions are executed.

R2-151, at 12-13. This language did not purport to waive the protection of res judicata. It did not even attempt to address the impact that a final federal court judgment would have on a subsequent arbitration. Rather, the arbitration clause merely recognized that, given the state of the law at the time the customer agreements were signed, arbitration of claims under the federal securities laws could not be contractually compelled.

Petitioners simply mischaracterize the nature of the parties' arbitration agreement. The clause is not, as petitioners maintain, an agreement to litigate part of a case and to reserve the rest for resolution in another forum. The agreement neither explicitly nor implicitly authorizes a party to proceed to final judgment in one forum and then to begin the controversy all over again in another, without any concern for the possibility that the first outcome would have a preclusive effect. The arbitration clause did not waive res judicata or any other claim or defense. The clause said nothing about what would happen if securities law claims were litigated to final judgment and petitioners subsequently began an arbitration arising out of the same transactions. Even petitioners do not contend that any such issue was ever actually negotiated and agreed upon by the parties.

Appellants' citation (Pet. 3, 11 n.8) of *Blue Gray Corporations I & II v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 921 F.2d 267 (11th Cir. 1991), is inapposite. *Blue Gray* held only that, under customer agreements like those involved here, Merrill Lynch cannot, from the outset of the proceedings, force a customer to arbitrate a federal securities claim that the customer wants to litigate, and the customer in turn cannot, from the outset of the proceedings, force Merrill Lynch to litigate a state law claim that Merrill Lynch would prefer to arbitrate. Nothing in the court of appeals' opinion or reasoning says or implies anything about the res judicata significance of a final federal court judgment in the context of a later attempt to arbitrate claims arising from the same transactions.

In sum, none of the arguments or authorities advanced by petitioners reveals any waiver of Merrill Lynch's res judicata claim. Nor do petitioners fare any better with their second rationale for opposing Merrill Lynch's position. Contrary to petitioners' contention, nothing in the parties' arbitration clause precluded petitioners from pur-

suing their state law claims in federal court. The fact that Merrill Lynch had the right to compel arbitration of those claims *if* it elected to do so is wholly irrelevant to whether petitioners *could have filed* those claims in the district court in the first instance. There was no requirement that Merrill Lynch move to compel arbitration of those claims.[5] The court of appeals correctly held, therefore, that "[t]he uncertainty of whether [Merrill Lynch] would move to compel arbitration of the state claims did not justify two proceedings." Pet. App. A-6.

Patting themselves on the back, petitioners contend that the "bifurcated proceedings" in this case were "brought about solely because Petitioners complied with an arbitration agreement" between the parties. Pet. 16-17. Petitioners warn that the rule adopted by the court of appeals "will force litigants to breach valid arbitration agreements in order to save their state-law claims from a claim preclusion defense . . . ." Pet. 16. This disingenuous spectre is belied by petitioners' actual conduct in this case. Petitioners were the ones who chose to pursue diametrically inconsistent theories, and petitioners were the ones who chose to wait until they had lost on one theory before making a 180-degree turn and asserting another. Petitioners' predicament is a product of petitioners' own tactical choices and their attempt to manipulate the system so as to enable themselves to take contrary positions without embarrassment or criticism. Their litigation posture has nothing to do with compliance with an arbitration agreement and everything to do with trying to play both ends against the middle.

Finally, petitioners err in suggesting that the decision below is somehow inconsistent with *Clark v. Bear Stearns & Co.*, 966 F.2d 1318 (9th Cir. 1992). The plaintiff

---

[5] *See New Process Steel Corp. v. Tital Indus. Corp.*, 555 F. Supp. 1018, 1020 (S.D. Tex. 1983) ("There is no basis in the case law to support the defendants' assertion that simply because a matter may be referable to arbitration, the Court is deprived of jurisdiction.").

in that case did just what petitioners here did not do—she brought *all* of her claims, including both federal securities law claims and state common law claims, in a single federal lawsuit. In response to Bear Stearns' motion, and in accordance with the parties' pre-existing arbitration agreement, the district court then ordered arbitration of the state common law claims; it retained jurisdiction of the federal securities law claims because the parties' agreement did not authorize Bear Stearns to compel arbitration of such claims. The arbitration panel subsequently dismissed all of the common law claims against Bear Stearns.

It was under these circumstances that both the district court and the court of appeals held that the federal securities law claims—*i.e.*, the claims that remained in federal court from the outset—were not barred by res judicata. Those claims were originally filed in federal court, and the federal court at all times retained jurisdiction over them. The plaintiff did not try, as petitioners have here, to proceed first in one forum and then in another.[6]

---

[6] Although the court of appeals did not address the point, the injunction preventing petitioners from continuing with their arbitration was also proper because petitioners waived their right to arbitrate. Such a waiver can occur even if it is not subjectively intended. Despite the federal policy favoring arbitration, courts frequently find that a party, by its acts or omissions, has waived its right to compel arbitration. Such a waiver can occur in a variety of circumstances, but it usually arises from delay in requesting arbitration or other conduct that is found to be inconsistent with an arbitration demand, such as engaging in extended discovery or taking other significant litigation steps before seeking to compel arbitration. Here, petitioners waited for more than three years before demanding arbitration and during that period petitioners engaged in protracted litigation, including extensive pre-trial discovery. In such circumstances, courts have held, even in the absence of the preclusive effect of a final judgment, that parties have waived their right to arbitrate. *See, e.g., Midwest Window Systems v. Amcor Industries*, 630 F.2d 535 (7th Cir. 1980); *S & H Contractors, Inc. v. A.J. Taft Coal Co.*, 906 F.2d 1507 (11th Cir. 1990), *cert. denied*, 498 U.S. 1026 (1991); *Stone v. E.F. Hutton & Co.*,

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

BENNETT FALK
MORGAN, LEWIS & BOCKIUS
5300 Southeast Financial Center
200 South Biscayne Boulevard
Miami, Florida 33131
(305) 579-0390

November 17, 1993

PETER BUSCEMI *
JOHN P. SIMMONS
MORGAN, LEWIS & BOCKIUS
1800 M Street, N.W.
Washington, D.C. 20036
(202) 467-7190
Counsel for Respondent
* Counsel of Record

---

898 F.2d 1542 (11th Cir. 1990); *Peterson v. Shearson/American Express, Inc.*, 849 F.2d 464, 467-68 (10th Cir. 1988); *E.C. Ernst, Inc. v. Manhattan Construction Co.*, 551 F.2d 1026 (5th Cir.), *modified on petition for reh'g*, 559 F.2d 268, 269 (5th Cir. 1977), *cert. denied*, 434 U.S. 1067 (1978).